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No. 87-1167

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1987

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

DONALD E. CLARK AND PEGGY S. CLARK,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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QUESTION PRESENTED

When respondent's company was acquired, by a publicly held company, in a tax-free reorganization, respondent received 300,000 shares of common stock and chose to receive cash instead of 125,000 additional shares of the acquiring company's stock. The question presented is whether, under section 356(a)(2) of the Internal Revenue Code, the cash he received in lieu of additional stock should have been taxed as a capital gain or as a dividend.

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OPINIONS BELOW

The opinion of the Court of Appeals (Pet. App. 1a-14a) is reported at 828 F.2d 221. The opinion of the Tax Court (Pet. App. 15a-39a) is reported at 86 T.C. 138.

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JURISDICTION

The judgment of the Court of Appeals (Pet. App. 40a) was entered on September 4, 1987. The petition was (taking account of extensions of time) timely filed on January 11, 1988 and received by respondent on January 14, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Donald Clark, the respondent,[1] was the sole shareholder of Basin Surveys, Inc., a West Virginia corporation engaged in the business of providing technical services to the petroleum industry. In 1978, N.L. Industries (NL), a publicly held company listed on the New York Stock Exchange, initiated negotiations with Clark over the possible acquisition of Basin. In the final negotiating session, NL offered Clark two alternatives as the price NL was willing to pay for the stock of Basin: Clark had a choice of receiving (1) 425,000 shares of NL common stock, or (2) 300,000 shares of NL common stock and, instead of the additional 125,000 shares, $3.25 million in cash. After considering the alternative proposals, Clark decided to accept the offer which provided him with cash

[1] Mr. Clark's wife, Peggy S. Clark, is a party solely because she filed a joint return with her husband for the year in question.

in lieu of the additional shares of stock.[2] In April 1979, the acquisition was consummated on that basis.[3]

As a result of Clark's acceptance of the combined stock and cash offer, the total number of NL common shares outstanding increased to approximately 32,833,000 shares, and Clark's stockholdings represented approximately 0.92 percent of that total. If Clark had accepted the all-stock offer of 425,000 shares, the total number of NL common shares outstanding would have increased to approximately 32,958,000 shares, and Clark's stockholdings would have represented approximately 1.3 percent of that total. (Pet. App. 16a.) Clark's 300,000 share ownership of NL after the transaction was 70.6 percent of the 425,000 shares he would have owned had he taken the all-stock offer.

The transaction qualified as a "reorganization" under Section 368(a)(1)(A) and (a)(2)(D) of the Internal

[2] In the Tax Court, Clark's attorney testified (and it was agreed that, if called, Clark would testify to the same effect) that Clark originally sought NL stock as the sole consideration for his Basin stock (C.A. App. 49-50). Also at trial, the official who represented NL in the negotiations testified that NL was prepared to go forward with the transaction on the basis of either alternative; that it did not know which offer Clark would accept; that its preference was to pay Clark a portion of the consideration in cash as a means of reducing the number of shares of NL stock that would be outstanding after the acquisition; and that the amount of cash offered to Clark was based on NL's determination of the value of the additional 125,000 shares that it would have had to issue to Clark in the all-stock proposal. (C.A. App. 36-37).

[3] The acquisition was structured as a merger of Basin into a wholly owned subsidiary of NL.

Revenue Code of 1954.[4] (Pet. App. 16a-17a.) Under Section 356(a)(1), Clark was required to pay tax on the $3.25 million cash or "boot" payment to the extent of his gain on the transaction with NL. Since Clark's gain (after taking into account the cash and market value of the NL stock received by Clark in exchange for his Basin stock) exceeded the amount of cash received, Clark reported the entire cash payment as gain, taxable at long term capital gain rates under Section 356(a)(2).[5] On audit, the IRS determined that the cash received by Clark had "the effect of a distribution of a dividend" under Section 356(a)(2) and was, therefore, taxable as a dividend.[6] Because, in 1979, dividends were taxable at ordinary income rates, while capital gains were taxed at only 40 percent of ordinary rates, this determination resulted in an asserted deficiency of $972,504.74 in federal income taxes for 1979.

Clark petitioned the Tax Court for review of the IRS determination. A trial was held in the Tax Court at which Clark, the NL official who represented NL in the acquisition, and Clark's attorney provided testimony on the negotiations between the parties. The Tax Court, in a reviewed decision with no dissents among the fifteen participating judges, held in favor of the respondent. (Pet.

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[4] All statutory references are to the Internal Revenue Code of 1954, as in effect for the year 1979, unless otherwise specified.

[5] Because of a computational error, the amount of gain actually reported on the return was $3,195,294. In his later computation for entry of decision by the Tax Court, Clark stipulated that the amount of gain recognized and reported should have been $3,250,000.

[6] Pursuant to sec. 356(a)(2), the amount claimed to be taxable as a dividend was $2,319,611, the accumulated earnings and profits of Basin on the acquisition date.

App. 15a-39a.) The Fourth Circuit affirmed, with no dissents. (Pet. App. 1a-14a.)

The Fourth Circuit and the Tax Court considered the two circuit court cases which had previously addressed the issue presented here—*Wright v. United States*, 482 F.2d 600 (8th Cir. 1973) and *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979). Both courts agreed with the approach adopted by the Eighth Circuit in *Wright*, which produced capital gain treatment, and both rejected *Shimberg*, which would have yielded dividend treatment, as a case in which the Fifth Circuit had reached the contrary result because it (and the district court whose decision it reversed) had misunderstood the court's holding in *Wright*. (Pet. App. 13a, 27a-29a.)

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ARGUMENT

Summary

The decisions of the Court of Appeals and the Tax Court are correct. They are in accord with basic tax principles applicable in the dividend equivalency and reorganization areas, the decisions of this Court and other federal courts, the views of numerous tax commentators and the American Bar Association, and the legislative recommendations of the staff of the Senate Finance Committee. Indeed, the Treasury Department has agreed to a proposed legislative amendment that would codify the approach adopted below; and the Commissioner himself, has a long-standing, published position which is at odds with the

position advanced on his behalf in the Court of Appeals and in the petition.

Petitioner overstates the administrative importance of the alleged conflict between this case (and *Wright*) on the one hand and *Shimberg* on the other. Because of the elimination of favorable capital gains rates, in the case of individual shareholders no practical consequence normally attaches any longer as to whether boot is treated as a dividend or as capital gain. It is true that corporate shareholders generally pay lower taxes if, contrary to the opinion below and in *Wright*, boot is treated as a dividend (because of the 80 or 70 percent dividends received deduction). However, if, as suggested in the petition, the Commissioner were to adopt the approach of the courts below, it is unlikely that such corporate taxpayers would rely on the opinion in *Shimberg*, which is widely regarded as a "sport," to classify boot such as existed here as dividends. In any event, it is premature for petitioner to ask this Court to resolve the alleged conflict, when no such effort to use *Shimberg* to reduce future revenues has arisen and when the issue presented apparently has not been resolved within the Government's own ranks.

Discussion

1. *The decision below is clearly correct.* The law at issue here is easily summarized: In a corporate acquisition which qualifies as a "tax-free" reorganization under Section 368, if a shareholder of the acquired corporation receives (in addition to stock in the acquiring company) cash or other property ("boot"), he or she must recognize gain on the transaction up to the amount of the boot received (Section 356(a)(1)). That gain is a capital gain unless the receipt of boot "has the effect of the distribution of a dividend," in which case the shareholder must treat it as a dividend (taxed at higher rates in the year at issue) up to his or her ratable share of accumulated earnings and profits of the corporation. Section 356(a)(2). The sole issue here is, therefore, whether the cash payment to Mr. Clark had "the effect of a dividend" within the meaning of Section 356, so that, under the rate structure then in effect, it should have been taxed as ordinary income rather than as the capital gain he reported.

a. *The court below correctly looked to Section 302 for guidance.* The initial question considered below is the source of guidance by which to identify a dividend. Section 356 does not contain any guidelines by which to discern the "effect of a dividend." However, Section 302 contains general principles for determining when a distribution of cash by a continuing corporation is equivalent to a dividend and when it results in the distributee shareholder's parting with a sufficiently large interest in the corporation to qualify for sale or exchange treatment.[7] Virtually all

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[7] Under Section 302, the distribution qualifies for capital gain treatment if it satisfies one of the following three tests:

(1) The distribution is "not essentially equivalent to a dividend." Section 302(b)(1). This has been interpreted to mean that the distribution effects a "meaningful reduction" in the shareholder's percentage interest. *United States* v. *Davis*, 397 U.S. 301, 313 (1970). In the case of a minority shareholder, virtually any reduction in his percentage interest is considered "meaningful." *See, e.g.*, Rev. Rul. 76-385, 1976-2 C.B. 92 (reduction from 0.0001118 percent to 0.0001081 percent).

(2) The distribution effects a "substantially disproportionate" redemption of stock. Under Section 302(b)(2), this means

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of the courts which have considered the question, including the courts below, have held that the principles of Section 302 should be applied in determining dividend equivalency under Section 356(a)(2). *See, Wright v. United States, supra,* at 605; *King Enterprises, Inc. v. United States,* 418 F.2d 511, 520-21 (Ct. Cl. 1969); *Ross v. United States,* 146 Ct. Cl. 223, 173 F. Supp. 793, 797, *cert. denied,* 361 U.S. 875 (1959); *Hawkinson v. Commissioner,* 235 F.2d 747, 751 (2d Cir. 1956). *See also Shimberg v. United States, supra,* at 287 n. 13 (stating that Section 302 applies in "appropriate cases").

As noted by the Fourth Circuit, "there are several persuasive reasons why § 302 should be used in determining whether boot should be taxed as ordinary income." (Pet. App. 5a.) Most importantly, Section 302 and Section 356 address the same issue—whether a particular corporate distribution should be treated as a dividend or as a sale or exchange of a portion of the shareholder's interest in the corporation. The two sections also contain similar language.[8] Finally, this interrelationship between the two sections has been expressly recognized by Congress. In

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that immediately after the distribution, the percentage interest of the distributee shareholder in the voting stock of the corporation must be (i) less than 50 percent, and (ii) less than 80 percent of what it was immediately prior to the distribution.

(3) The distribution effects a complete termination of the distributee shareholder's equity interest in the corporation. Section 302(b)(3).

[8] Section 302(b)(1) provides for ordinary income treatment if the distribution is "essentially equivalent to a dividend," while Section 356(a)(2) treats boot as ordinary income if it "has the effect of a distribution of a dividend."

the Conference Committee Report for the Deficit Reduction Act of 1984, which made changes in the reorganization provisions, it is stated unequivocally that "[t]he principles of section 302 are applicable in testing for dividend equivalency under section 356." H.R. Conf. Rep. No. 98-861, 98th Cong. 2d Sess. 1, 845 (1984-3 C.B. (Vol. 2) 1, 99).[9]

On appeal to the Fourth Circuit, the Commissioner challenged this proposition and argued that the principles of Section 302 are not applicable in the reorganization context, and that, under special standards to be developed for Section 356(a)(2) only (presumably on a case-by-case basis), a distribution such as the one here should be treated

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[9] This Court has recognized that such express Congressional recognition of the judical and administrative interpretation of a statute should be given great weight in determining the meaning of the relevant provisions. *Cf. Lorillard v. Pons,* 434 U.S. 575, 580 (1978). Apart from the statement in the Conference Committee Report, the 1984 amendment, itself, requires the conclusion that the principles of Section 302 apply in determining dividend equivalency under Section 356(a)(2). The amendment adds language to Section 356(a)(2) to make it clear that the question of whether a distribution has the effect of a dividend is to be "determined with the application of [the attribution rules of] section 318(a)." This amendment would have little, if any, meaning unless it were assumed that the tests for determining dividend equivalency contained in Section 302 are applicable. Thus, the tests contained in Section 302 require a determination of the shareholder's percentage interest in the corporation before and after the distribution. For purposes of this determination, stock owned by individuals and entities which are related to the shareholder, within the meaning of Section 318, are deemed to be owned directly by the shareholder. Unless the Section 302 test of a change in ownership interest were to be applied for Section 356(a)(2) purposes, there would be no need for an attribution rule to compute such ownership interests.

as a dividend.[10] The Fourth Circuit was troubled by the Commissioner's new approach: "[I]n return for abandoning the § 302 analysis, the Commissioner offers no realistic alternative, except perhaps a return to the abandoned rule that any pro rata distribution in a reorganization must automatically be treated as a dividend."[11] (Pet. App. 6a.) The Fourth Circuit squarely rejected the petitioner's general argument and instead "join[ed] the long line of courts that have applied § 302 in the reorganization context." (Pet. App. 6a.) Petitioner does not, in this Court, mount a general attack on the use of Section 302, only on its application, but once Section 302 is applied, the holding below necessarily follows.

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[10] It should be noted that, although petitioner's litigating position before this Court is now one of agnosticism as to whether Section 302 applies, the official position of the Internal Revenue Service is that the principles of Section 302 do indeed apply in determining dividend equivalency under Section 356 (a)(2). *See*, Rev. Rul. 75-83, 1975-1 C.B. 112; Priv. Ltr. Rul. 8728037 (April 13, 1987); Priv. Ltr. Rul. 8748038 (September 1, 1987).

[11] As a result of *dicta* in *Commissioner* v. *Bedford's Estate*, 325 U.S. 283, 292 (1945), for many years it was assumed that cash or property other than qualifying stock or securities received in a corporate reorganization would always have the effect of a taxable dividend to the extent of the corporation's accumulated earnings and profits. This "automatic dividend" rule came under increasing criticism, however, as being "difficult to reconcile" with the language of Section 356(a)(2), which implies that certain distributions might have the effect of a dividend while others might not. *See e.g., Hawkinson v. Commissioner*, 235 F.2d 747, 750-51 (2d Cir. 1956). As a result, the courts and the Internal Revenue Service have now retreated from the automatic dividend rule. *See e.g., Wright v. United States, supra*, at 605; *Shimberg v. United States, supra*, at 287; *King Enterprises, Inc. v. United States*, 418 F.2d 511, 520 (Ct.Cl. 1969).

b. *The court below properly treated the transaction as an integrated whole, considering the effect of receiving cash on the taxpayer's interest in the continuing business.* This Court has established that the basic characteristic of a dividend is a distribution to shareholders "without a change in the relative economic interests or rights of the shareholders." *United States v Davis*, 397 U.S. 301, 313 (1970). Section 302, in accord with that principle, measures whether exchange, rather than dividend, treatment is appropriate by considering whether the shareholder has experienced a significant reduction in his ownership interest as a result of the cash payment, so that the transaction is treated as a sale or exchange, of a portion of that ownership interest for cash. In a tax-free reorganization, such as occurred here, measuring the effect of the cash requires measuring the effect of the distribution on the taxpayer's interest in the combined corporation that emerged from the transaction—here NL. This follows because the "essence of [a tax-free reorganization] is a continuance of the proprietary interests in the continuing enterprise under modified corporate form." *Lewis v. Commissioner*, 176 F.2d 646, 648 (1st Cir. 1949); *see also*, Treas. Reg. § 1.368-1(b).

Consistent with these principles, the courts below held that the relevant inquiry was to compare the economic interest that Clark had in the continuing enterprise, NL, as a result of receiving the boot distribution with what that interest would have been had no boot been received.[12]

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[12] (Pet. App. 14a, 34a-35a.) It is a measure of the degree to which the result below turns on the particular facts of this case that the Fourth Circuit, like the Tax Court, stressed that, on

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Specifically, applying Section 302, the Fourth Circuit concluded that the transaction should be examined as an integrated whole, in which "the tax consequences . . . should reflect the reality of Clark's choice to forego 125,000 shares of N.L. stock," not, as petitioner argues, as if the receipt of the cash were a transaction entirely separate from the simultaneous and related transfer of the company to NL. The Fourth Circuit found, "by taking the cash, Clark surrendered his potential interest in N.L. to the extent of almost 30%." Accordingly, he was entitled, under Section 302, to treat the income as capital gain.[13]

The integrated approach adopted by the courts below is also in accord with the established principle of tax law known as the "step transaction" doctrine. Under this doctrine, rather than giving separate consideration to each of the various steps which comprise an integrated transaction, the steps are viewed together in light of the overall transaction to determine their tax effect. *See e.g. Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938); *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954). The courts below approached the facts of this case from an "integrated perspective." (Pet. App. 13a.) They focused on

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this record, there was direct and unchallenged evidence of what the taxpayer's interests in NL would have been had he not received the boot, because he was offered a direct choice of the cash or 125,000 more shares of NL stock.

[13] Here, as the Tax Court pointed out, because Clark experienced more than a 20 percent reduction in his potential ownership interest in NL, the transaction qualified for sale or exchange treatment under the "safe harbor" of Section 302(b)(2). (Pet. App. 34a-35a.)

the overall transaction and, in accordance with both historical fact and economic reality, treated the cash boot as a payment in consideration for Clark's acceptance of a lesser interest in the continuing enterprise which emerged from the reorganization.

In contrast, the Commissioner's approach—and that of *Shimberg*—is to ignore the overall effect of the transaction and treat the cash payment in isolation, as having been made "pro rata" to Clark as a stockholder of Basin, while that company was still in existence and Clark was still its sole shareholder.[14] The Commissioner, following *Shimberg*, would measure the effect of the distribution as though it had occurred as an independent transaction, and he would ignore its effect on Clark's ownership interest in NL, the continuing enterprise in the reorganization.[15]

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[14] Petitioner assiduously tries to avoid acknowledging that his position is one which requires a fragmented view of the distribution. However, as the Fourth Circuit observed (Pet. App. 7a-8a), the Government's "pro rata" approach is necessarily based on the view that Clark received the $3,250,000 from Basin before that company was merged into NL. For the distribution in issue here can be viewed as pro rata only if it is viewed as having been made to Clark while Basin was still in existence and he was still its sole shareholder. In contrast, the distribution clearly would not be pro rata if it were viewed as having been made by NL to Clark simultaneously with his becoming a stockholder of NL in exchange for shares in that company, since only he and not the other shareholders of NL received cash.

[15] Again, the facts of this case underlie the analysis of the courts below and highlight the unrealism of the Commissioner's position. Thus, as the Tax Court pointed out, the facts make it especially difficult to view this case as involving a pre-reorganization distribution by Clark's company, since that company had nowhere near enough money to have paid the cash

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The more realistic, integrated method of analysis used by the courts below had previously been adopted by the Eighth Circuit in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973). It has been endorsed by numerous commentators and by the American Bar Association,[16] and recommended for statutory codification by the Staff and the Chairman of the Senate Finance Committee.[17] *Shimberg*—with its contrary, artificial analysis of the receipt of the cash boot as unrelated to the simultaneous receipt of stock—is regarded as an aberration, resulting from a

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itself. Accordingly, here there was no issue of a pre-reorganization distribution of a cash accumulation. Pet. App. 37a. Indeed, the amount of cash received by Clark was much greater than the amount of Basin's liquid assets or the book value of its net equity—illustrating the contrived nature of the Government's notional "dividend" of the cash by Basin just before an unrelated stock-for-stock exchange with NL. In short, contrary to the Government's assertion, there is no economic basis for treating the cash received from NL as a bail-out of Basin's earnings, rather than a payment by NL in lieu of additional NL stock.

[16] *See* ABA Legislative Recommendation 1983-8 (approved by ABA House of Delegates at 1984 Midyear Meeting); Levin, Adess, & McGaffey, "Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency," 30 Tax Lawyer 287, 288 (1977); Golub, "'Boot' in Reorganizations—The Dividend Equivalency Test of Section 356(a)(2)," 58 Taxes 904, 911-13 (1980); Fleming, "Reforming the Tax Treatment of Reorganization Boot," 10 J. Corp. Tax 99, 107-110 (1983).

[17] *See* Staff of The Committee on Finance United States Senate, 98th Cong., 1st Sess., *The Reform and Simplification of the Income Taxation of Corporations*, 63 (S. Prt. 98-95, 1983); Staff of The Committee on Finance United States Senate, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985*, 6, 217-18 (S. Prt. 99-47, 1985); Joint Committee on Taxation, 99th Cong., 2d Sess. *Tax Reform Proposals in Connection with Committee on Finance Markup* (JCS 8-86), March 18, 1986.

misreading—both by the Fifth Circuit and by the district court it reversed—of the *Wright* approach adopted by the courts below in this case.[18]

c. *The Executive Branch has already agreed to accept legislation codifying the analysis of the court below.* In fact, the executive branch has already decided that the approach taken by the courts below and challenged by petitioner here is acceptable as a matter of tax policy. A major study of revision of "Subchapter C" of the Internal Revenue Code, that is, of the provisions dealing with taxation of corporate distributions and reorganizations, has been underway for the past several years. One of the issues considered has been the proper treatment of transactions such as Clark's sale of his business. Consistent with the recommendations of the American Bar Association's special committee on the question, the staff of the Senate Finance Committee recommended in 1983 that the *Wright* analysis, adopted by the courts below in this case, should be expressly codified in the statute and the *Shimberg* approach rejected.[19]

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[18] Specifically, it seems clear that the *Shimberg* court understood the taxpayer there to be arguing that under *Wright*, the relevant comparison was between his dominant ownership percentage in the acquired company and his small minority ownership in the post-acquisition company, not between what his ownership in that continuing company would have been with and without the boot. *See* Pet. App. 13a, 28a. *See also General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980) where, as the Tax Court pointed out, "[t]he Fifth Circuit's misunderstanding of the *Wright* holding is even more clearly evidenced. Pet. App. 28a, n. 8.

[19] *See* nn. 16 and 17.

In 1983, the Treasury Department, through the Office of the Assistant Secretary for Tax Policy, the agency charged with developing tax policy for the executive branch, presented its formal position on the recommendation. Viewing *Wright* and *Shimberg* as offering alternative tax approaches to the same question, and reviewing the arguments on both sides, the Treasury statement described the matter as "a very close call," and concluded that "on balance, we do not object to the Staff's recommended approach," which it described as measuring whether boot has the "effect of a dividend" by look[ing] to the shareholders' reduction in interest as measured *after* the acquisition."[20] That approach is exactly the analysis employed by the court below in this case.

The effect of this statement of the Treasury Department's position is that, in urging this Court to hear this case and decide it on the basis of *Shimberg*, petitioner is in the anomalous position of asking this Court for the opportunity to persuade it of a position the tax policy authorities have already decided is "on balance" incorrect.

On all counts, therefore, the approach adopted by the court below is, and is widely regarded as, sound and correct. Indeed, it has been accepted by the tax policy authorities of the executive branch.

2. *There is no conflict requiring this Court's attention.* Petitioner also claims that, apart from alleged de-

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[20] *See Reform of Corporate Taxation: Hearing Before the Committee On Finance United States Senate*, 98th Cong., 1st Sess., 24-25 (S. Hrg. 98-556, 1983) (emphasis in original); *see also* Staff of The Committee on Finance United States Senate, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985*, 6 (S. Prt. 99-47, 1985).

fects on the merits, the conflict of the decision below with the 1979 Fifth Circuit decision in *Shimberg* will create significant problems for the administration of the tax laws unless this Court grants review. There are significant differences between the facts of this case and those of *Shimberg*,[21] but in any event, the petitioner greatly overstates the problems that would arise were this Court to decline to resolve the conflict now.[22]

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[21] In the present case, the taxpayer was actually offered a choice between an all-stock deal and a deal with less stock and cash; no such clear alternative was available to the seller in *Shimberg*. Also, here, as contrasted to *Shimberg*, the acquired corporation did not have sufficient accumulated earnings and profits, or net assets, much less cash, to cover the amount of cash paid to the seller in the reorganization.

Although petitioner finds a "clear conflict" to be present here, it should be noted that, in 1978, the Government opposed the taxpayer's petition for certiorari in *Shimberg* on the tenuous factual ground that the holding of that case did not conflict with the holding in *Wright*, because in the latter case the acquired and acquiring corporations were controlled by the same interests. There is not the slightest suggestion in the *Wright* opinion that the approach adopted there, and the underlying rationale for that approach, were based on the fact that the acquired and acquiring corporations were related entities. Moreover, apart from the Government in its Brief in Opposition in *Shimberg*, everyone else who has considered the *Wright* case (including the courts, Congress, commentators and even the Internal Revenue Service—see Rev. Rul. 75-83, 1975-1 C.B. 112—and the Treasury Department in its comment on Subchapter C revision) has interpreted *Wright's* holding to be applicable in cases involving unrelated corporations and therefore in conflict with *Shimberg*.

[22] Whatever the merits of petitioner's contention that the decision below conflicts with *Shimberg*, there is no merit to his contention (Pet. 8) that the decision below conflicts with other circuit court cases. As the Tax Court pointed out, in *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct.Cl. 1969), there was no dispute that the dividend determination should be made with

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Most important, insofar as the decision below aids taxpayers who want to treat income as capital gain rather than dividends, the issues treated in this case, in *Wright* and in *Shimberg*, are of no continuing importance. The practical impact of the characterization of "boot" as capital gain rather than ordinary income has been almost entirely eliminated by the abolition, in the 1986 Tax Reform Act, of the lower tax rate for capital gain income of both individuals and corporations.[23] Petitioner argues (Pet. at 9 n.6) that the elimination of the differential rates may be "something of an experiment." The possibility that Congress might at some future point reverse a basic tax policy decision of the 1986 Act is far too speculative to justify this Court reviewing a decision on the basis of the significance it would have only if that reversal occurred.

Moreover, as noted above, the executive branch tax policy authorities have already agreed to accept a codification of the result in this case as a part of a pending broad revision of the taxation of corporate reorganiza-

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references to the acquired corporation," while in *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956), the appeals court "clearly did not confront the issue of choice between the acquired and the acquiring corporation." (Pet. App. 24a, n. 7.)

[23] Petitioner's claim (Pet. at 10-11) that acceptance of the decisions below and in *Wright* would require other adjustments, *e.g.*, to the amount of gain, basis in the acquired stock, and earnings and profits is simply incorrect. As the Fourth Circuit pointed out, the issue of the *character* of the boot income—governed by Section 356(a)(2) and (even according to the IRS in Rev. Rul. 75-83) Section 302—is entirely separate from the issue of the *amount* of such gain and the effect of the transaction on earnings and profits. These latter issues are provided for in detail in Section 356(a). (*See* Pet. App. 6a.)

tions. General revision of Subchapter C, including codifying the method of analysis that led to the decision below, remains on the Congressional agenda.[24] If it is appropriate to consider the prospect of future action by Congress in deciding whether this Court should hear tax cases, it is far more reasonable to assume that Congress will in the near future enact the pending general Subchapter C revisions, which are relatively non-controversial, than that it will restore the capital gain/ordinary income differential, which would be a major policy change.

Petitioner also suggests that, even without a capital gain/ordinary income differential, there will be serious tax administration problems if this Court does not inform the tax world whether *Shimberg* on the one hand, or the decisions below and in *Wright*, on the other, correctly states the law. Specifically, petitioner suggests that, while most taxpayers are now largely indifferent to the character of boot income, some corporate taxpayers actually prefer the result in *Shimberg*, because an expansive scope for dividend treatment will make boot income subject to the corporate "dividends-received" deduction.[25]

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[24] Indeed, provisions to effect such a revision, including codifying the analysis used below as previously accepted by Treasury, was included at one point in the 1986 Act, and dropped only because of the desire not to attempt to effect this complex but essentially technical change amid the controversy over the 1986 Act. *See* Joint Committee on Taxation, 99th Cong., 2d Sess., *Tax Reform Proposals in Connection with Senate Finance Committee Markup*, (JCS 8-86), March 18, 1986.

[25] As a result of an amendment to Section 243 included in the Budget Reconciliation Act of 1987, the dividends-received deduction is currently equal to 80 percent of the amount of

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Petitioner's specter of corporate taxpayers relying on *Shimberg* to deny the Government revenues by improperly expanded dividends-received deductions is overdrawn and implausible. *Shimberg's* analysis has been heavily criticized by commentators, and it is viewed by the tax bar generally as an aberrational decision, occasioned by misinterpretation of the approach adopted in *Wright* and followed in this case. *Shimberg's* rejection by the courts below would be a further deterrent to corporate tax managers relying on its authority.[26]

In any event, if the Internal Revenue Service wishes to protect the revenues from unjustified reliance on *Shim-*

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the dividend in the case of corporate shareholders owning 20 percent or more of the outstanding stock of the distributing corporation, and 70 percent of the amount of the dividend in the case of all other corporate shareholders. *See* H.R. Conf. Rep. No. 100-495, 100th Cong., 1st Sess., Part III at 425 (1987).

[26] The decision below has already been described as likely to reduce the possibility for abusive reliance on *Shimberg* by Wall Street arbitragers seeking to use dividends-received deductions in the context of acquisitive reorganizations. Such arbitragers purchase stock in a corporation before an acquisition transaction is closed and realize profits on the spread between the market price and the takeover price. If the acquisition is structured as a tax-free reorganization including some cash distribution to shareholders of the acquired corporation, corporate arbitragers could, embracing *Shimberg* and the petitioner's position in this Court, treat the boot (up to the amount of their gain on the arbitraging transaction) as a dividend, taxed at a much lower effective rate (after giving effect to the dividends received deduction) than if the boot were treated as capital gain on the transaction. According to a tax partner at one of the national accounting firms, "This [Clark] decision could eliminate many arbs from the takeover game" in which they have sought to reclassify cash payment of boot as dividends. *See* "Tax Court Decision Could Ruin Risk Arb Biz," Investment Dealers' Digest (February 17, 1986), p. 2. (A copy of this article is attached to respondent's appellate brief as Appendix 2).

berg, it has many resources of its own to bring to bear before it can justifiably ask this Court to intervene.[27] Petitioner routinely publishes revenue rulings or "acquiescences" declaring that it will henceforth follow certain cases.[28] To the degree that petitioner's concern is being whipsawed, he could greatly relieve that concern by publishing an announcement that *Wright* and the decision below and not *Shimberg* are to be followed in characterizing boot, for purposes of the dividends-received deduction as well as otherwise.

In the face of such action by petitioner—and the general weakness of *Shimberg* as a precedent—it would be a hardy corporate taxpayer indeed that would rely on *Shimberg* to expand its dividends-received deduction.[29] Those who did so would face a formidable hurdle in gaining judicial acceptance of their position, even in the Fifth

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[27] If, for some reason, petitioner *wants* corporate taxpayers to remain able to reduce their taxes by taking advantage of *Shimberg*, he need do nothing at all.

[28] Having issued such an announcement, petitioner would, of course, abide by it in ruling on reorganizations, thereby dealing with the need for "the IRS to have a uniform rule to apply in issuing these rulings." (Pet. at 11). In fact, petitioner has followed this very procedure in communicating to taxpayers his position disagreeing with the opinion in *Wright* and subsequently applying that position to taxpayers requesting rulings on reorganization transactions. *See* Rev. Rul. 75-83, 1975-1 C.B. 112; e.g., Priv. Ltr. Rul. 8640064 (July 9, 1986).

[29] Indeed, in the face of a disavowal by the Commissioner of *Shimberg*, together with the widely held view (expressed by the courts below, as well) that *Shimberg* was wrongly decided, it is not even clear that *Shimberg* would constitute "substantial authority" sufficient to avoid a penalty under section 6661 for substantial understatement of taxable income, at least in the case of taxpayers residing outside of the Fifth and Twelfth circuits. *See* Treas. Reg. § 1.6661-3.

and Twelfth Circuits in which *Shimberg* is nominally authority. The chance that the petitioner would be unable to persuade those circuits to reconsider *Shimberg* seems small, but for present purposes it is sufficient to observe only if such an effort failed would review by this Court be appropriate.

3. *This Court should not attempt to resolve the issue presented here before it is resolved within petitioner's own ranks.* Petitioner has changed his position several times in this case on the proper analysis of the transaction at issue and still fails to present a position consistent either with his rulings in related areas or with the view of the tax policy authorities. In the Fourth Circuit, petitioner maintained that Section 302 principles do not apply at all in the case of a cash payment governed by Section 356(a)(2). This was contrary to petitioner's position in the Tax Court, in *Wright*, in Rev. Rul. 75-83, 1975-1 C.B. 112 (which is not mentioned in the petition, even though it is viewed by the IRS as the principal administrative pronouncement in this area) and in numerous private rulings (dealing with pro rata and non-pro-rata distributions in a reorganization) issued by the IRS, which conceded that Section 302 applied.

Petitioner's current attack on the Fourth Circuit decision before this Court, as outlined in the petition's extensive discussion of the merits, differs significantly from its fundamental argument to that court. There petitioner argued that the general "dividend equivalence" test of Section 302—under which the standard for being a dividend is whether the boot had the effect of substantially or "meaningfully" reducing Clark's equity interest—should not be applied at all in the reorganization context, where Section 356(a)(2) requires a determination of whether boot "has the effect of the distribution of a dividend." The Fourth Circuit clearly regarded that general attack on the applicability of Section 302 as the core of the Government's case and squarely rejected it. (Pet. App. 5a-6a.)

Now, having seen that position rejected when presented to the Fourth Circuit as the general issue posed by this case, petitioner takes a different and far less generalizable tack. Petitioner now declares only that "in the context presented here, there is no tension between the principles of Section 302 and the principles that should be applied under Section 356(a)(2)." (Pet. at. 19.) This shift in position, however, reduces the issue to whether the courts below—each of which explicitly applied the Section 302 rules to the Section 356(a)(2) problem—erred in applying the Section 302 rules to these particular facts, not whether they applied a correct standard.

Moreover, the tax policy authorities have already pronounced acceptable a codification of the analysis used below. Adoption by this Court of the position advanced by petitioner at this stage of the proceedings would only serve to confuse, rather than clarify, the state of the law in the corporate reorganization area. Even as reformulated, it is at odds with the approach of the Commissioner in Rev. Rul. 75-83 and in numerous private rulings. It

would be open to abuse and manipulation[30] and would, properly, be rejected by the IRS in many other situations as inconsistent with step transaction principles. And, as pointed out by the Fourth Circuit, in place of abandoning the principles of Section 302, it "offers no realistic alternative, except perhaps a return to the abandoned rule that any pro rata distribution in a reorganization must automatically be treated as a dividend." (Pet. App. 6a.)

Before this Court considers the issue presented here, petitioner should reconcile the differences within the executive branch.

* * *

In sum, petitioner is asking this Court to review the decision below to overturn a generally supported approach that the executive branch has already accepted in the legislative arena in favor of a position which has changed at each stage of this litigation. Moreover, it is doing so in a context of minimal continuing importance and where the petitioner himself should be able to eliminate any adverse effects on revenues from the conflict it perceives.

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[30] For an example of how the Government's approach might be manipulated, see the opinion below. (Pet. App. 12a.)

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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